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# Economic Report

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# Inflation: Down For The Count?

Although prices always go up more slowly during a recession only to rise more rapidly later on, the recent abatement of inflation has nevertheless sparked hopes that the United States economy's protracted bout with continually-rising prices may have taken a turn for the better. For one thing, the slowing of inflation this time has been much more rapid than usual. In the space of less than six months, we have gone from double-digit inflation to an actual price decline—the first time this has happened at the consumer level in nearly 17 years. Even more important, the "real world" is filled with examples of falling prices at all levels of production and distribution—not to mention wage concessions, too. To top it off, financial publications are replete with articles discussing the new environment of disinflation and its impact on business, individuals, and governments.

Coming after more than 30 years of ever-rising prices, these developments are most interesting—if not hopeful. But while it does appear that the behavior of prices has changed somewhat in recent months, it is too soon to let down our guard regarding the need to combat inflation. Indeed, it was just this kind of commentary about how inflation was licked and how the greater problem was getting out of recession in past business cycles that caused the slowing of inflation to be followed by even higher rates of inflation later on. The government would change policies to reflate economic activity, and once the economy showed signs of improving, inflation psychology would reawaken and we would be off and running once again.

### Core Inflation Has Declined...

To determine just how much fundamental progress we have made against inflation, it is necessary to look at the three components of it in order to see how each has changed in trend. First and foremost there is the "core" or underlying rate of inflation. This consists of the cost of labor and capital that business incurs and upon which it bases its prices. Of the two, labor costs count for twice as much as capital costs in the typical company. For a variety of reasons, including the way it is raised, capital costs tend to be steadier (and, in recent years, climbing), while labor costs, reflecting compensation and productivity developments, are affected by changes in the pace of economic activity, thus are more volatile. At any rate, it would appear that the core rate of inflation has, indeed, fallen somewhat over the past year and a half—but only to about eight percent, year-over-year. Since this is above the latest 12-month rise in consumer prices, you can see why corporate profits have been squeezed and why business failures are soaring.

It appears that no further significant reduction in core inflation is in sight over the near term. This is because slowdowns in the rate of wage gains (in some cases, actual declines in compensation) are being offset by poor productivity trends as a result of the weak economy. And of course, as long as interest rates remain high and the stock market stays depressed, the cost of raising capital will not come down, either.

### ...As Has Its Cyclical Component

The second aspect of inflation deals with the business cycle. As you might expect, when economic activity slows business finds it more difficult to raise prices, while labor finds it harder to raise wages. The protracted weakness that has characterized the U.S. economy, not only since summer 1981, but going back to 1979 or earlier in some sectors, has dampened interest in raising prices and wages. From a postwar record annual rise of more than 14 percent set in first-quarter 1980, the rise in consumer prices has slowed to less than seven percent in the most recent twelve months. As I pointed out in last month's Economic Report, the rate of inflation slows, not only during a recession, but for some time afterward as well. This is because of slack in both the labor force and in industrial capacity, as well as because of the productivity gains that usually arise during the early stages of recovery. Thus, on a cyclical basis alone, even assuming that the recent downturn in economic activity has come to a halt, there is every reason to believe that the slowing in inflation will continue for a number of months to come.

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At the moment, because of the prolonged slump in the U.S. economy, both prices and wages appear to be exhibiting a flexibility unprecedented since the 1930s. The regular monthly survey of the National Association of Purchasing Management reveals the highest number of purchasing managers reporting *lower* prices in three decades. On the wage side, there have been numerous instances where workers have "given back" wages, fringes, and working conditions with the intent of helping their employers reduce costs, hence save jobs. Some of these agreements have been in the form of pay cuts, while in other cases workers have been required to produce more at the same pay. In others, wages have been changed from fixed hourly salaries to incentive work where compensation is directly related to output, while benefits have been reduced elsewhere. These concessions have not been confined to blue-collar union members alone, but have spread to white-collar, non-union employees as well. Even more significant, in the case of labor contracts, many of these give-back agreements were renegotiated in mid-contract.

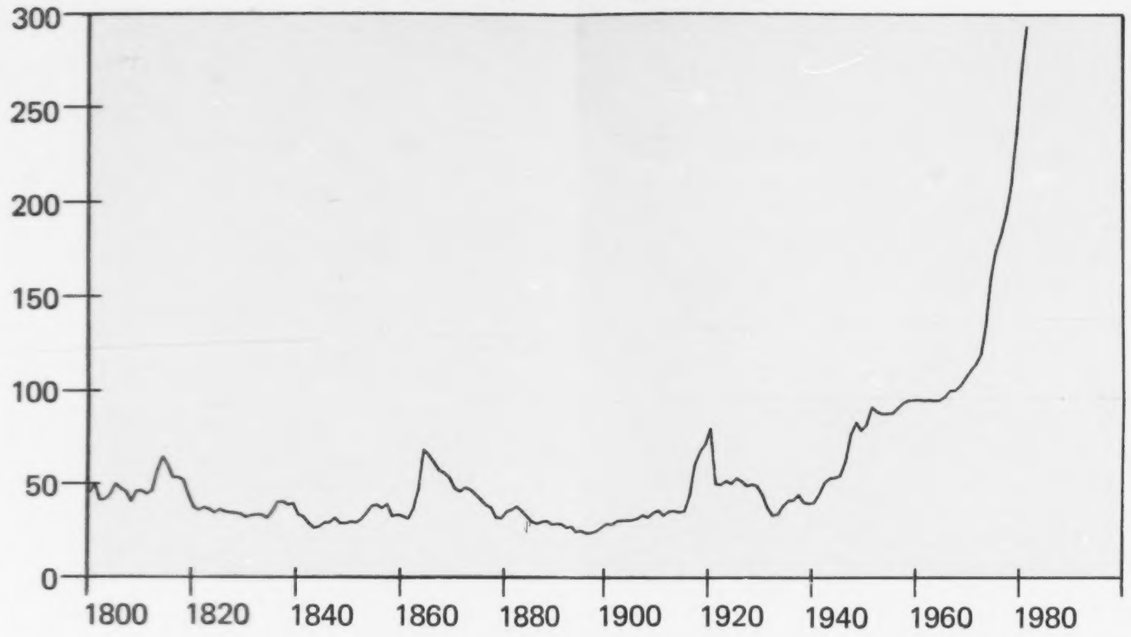
A complete list would be too numerous to mention, but examples include such key industries as automobiles, tires, airlines, steel, meat packing, trucking, and construction. Another aspect of labor costs, strike activity, continues to remain low. At the start of 1982, idleness due to worker walkouts as a percent of estimated available working time was at the lowest rate since World War II.

By its nature, however, the cyclical aspect of inflation cannot be counted upon to provide more than temporary relief. When demand firms up, business tends to abandon price discounting and tries to improve profit margins by boosting prices to the extent markets will allow. For its part, as labor sees employers beginning to earn more money again, it tends to abandon its concessionary stance and asks for increased wages and improvements in working conditions which usually result in higher labor costs. So while the cyclical aspect of inflation is indeed positive for the moment, and will continue so for some time to come, it cannot be counted upon to produce a permanently lower rate of inflation all by itself.

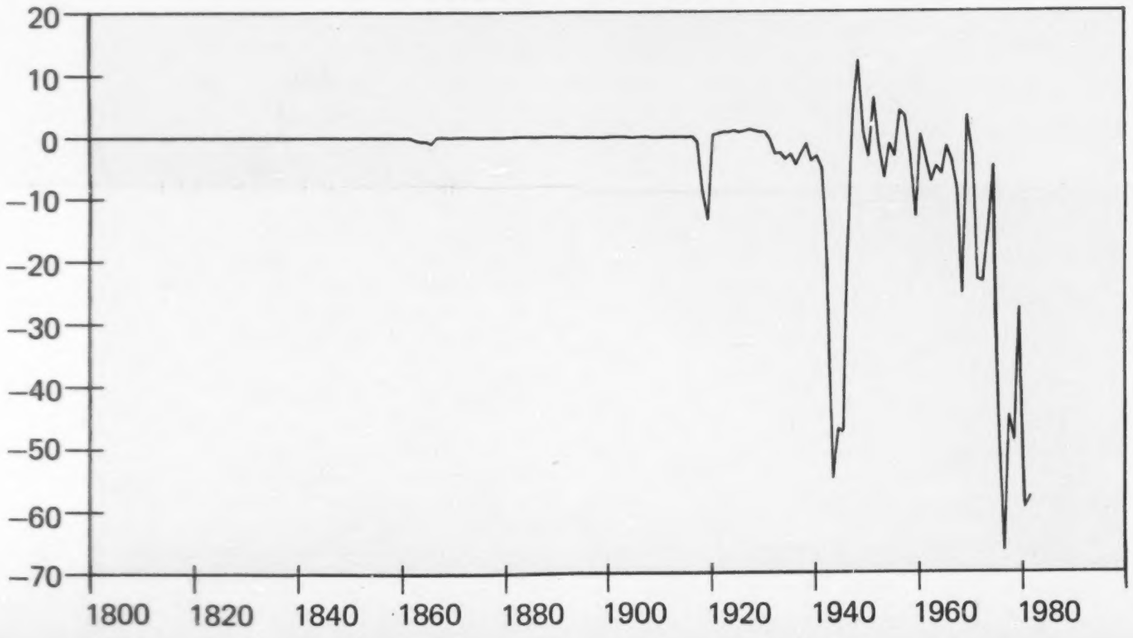
**Some Shocks May Not Reappear...**

The third component of inflation has been around as long as the price statistics have been assembled. It deals with shocks—sudden and unanticipated boosts to the price level which originate outside the normal trend in economic activity. They include, obviously, anything that has an abrupt effect on either demand or supply. I suppose that unusual weather represented the first shock that people had to contend with since it affected supplies of foods. Wars also constitute a shock as do such other government-administered developments as the imposition and lifting of wage and price controls. Sudden changes in the foreign exchange

PRODUCER PRICE INDEX, 1800–1981
ALL COMMODITIES, 1967=100




FEDERAL GOVERNMENT SURPLUS OR DEFICIT, 1800–1981
BILLIONS OF DOLLARS






value of currencies, abrupt changes in fiscal and monetary policies—and, since 1973, sudden changes in the price and availability of fuels constitute shocks as well.

To the extent that these can be anticipated (and, literally by definition, they are difficult to foresee), it would appear that shocks are unlikely to be an additive factor to inflation over the near term. Foodstuffs seem plentiful, while the same may be said for oil, suggesting that, at worst, prices of these two important commodities will be stable over the near term. The advent of floating exchange rates has reduced the probability of sudden shocks from foreign exchange, although the dollar has swung widely in recent years. Of course, the volatile situation in the Middle East and the South Atlantic should serve as constant reminders that the threat of war is ever-present.

Another shock element deals with government policies regarding controls. We saw how the after-effects of wage-price controls of the early 1970s and the credit controls of spring 1980 affected people, prices and markets. One would hope that controls will not be resorted to again in an effort to dampen price pressures but this will depend, not only on economic considerations but on politics as well—and you know how unpredictable politicians can be.

**...But Others Are Still Around...**

In the final analysis, the battle to lower inflation permanently will depend mainly on how the government runs its economic policy. In turn, this aspect will depend on the ability of the anti-inflation forces to generate and maintain a constituency. For as I noted earlier, just when it appeared that inflation had been licked in previous business cycles, the costs in terms of unemployment, the inability of business to adjust, etc. weakened the anti-inflation forces and encouraged the government to reflate.

Interestingly, as you can see from the top chart, inflation, for all its seeming longevity, is not a way of life for the U.S. There was virtually no inflation, point to point, between 1800 and the early 1940s. And even as recently as twenty years ago, producer prices were only twice their levels of the early 19th century. Since then, the trend has virtually been straight up. Notwithstanding the components I analyzed earlier, it would seem to me that the basic, underlying cause of inflation can be seen from the lower chart, and that is fiscal policy.

It is more than coincidental that the price spiral began when Washington started to run frequent and growing deficits in its budget. And while deficits, themselves, need not be inflationary, they turned out that way because the Federal Reserve replaced the money that Washington borrowed in the financial markets in order that there be some funds left for the private sector. As you know, this resulted in an expansion of the supply of

money and credit at a faster rate than the economy could absorb. In turn, this increased demand at a faster rate than supply — the basic definition of inflation.

What makes me reluctant to relax the vigil against inflation at this time is what seems to be the likely trend of government policy. We are at a point now where the three major components of inflation — shock, cyclical, and core — are either stable or heading downward. Inflation psychology is changing, witness price discounting by business and wage and benefit concessions by labor. But financial market participants remain wary, and are keeping interest rates high because of what they believe is coming in economic policy.

To be sure, few would question the Federal Reserve's current monetary posture or its intent to remain tight under "ordinary" circumstances. Indeed, it is the slowing of the growth in the money supply over the past several years that has been the major factor in the reduction of inflation. However, in the context of continuous budget deficits, this slowing in money growth has also made money less available and more expensive to the private sector, thereby contributing to recession as well (and, in the current instance, to half-century high rates of business failures). The markets are concerned that, in the absence of a significant reduction in the government's projected budget deficit, the Federal Reserve will have to yield in order to stave off a severe slump in economic activity — and in the process, will set off a new round of inflation.

### ...So We Can't Relax Just Yet

In actuality, reducing Washington's budget deficit is not all that will have to be done in order to further unwind inflation on a sustained basis. If business is to earn a decent rate of return, the core rate of inflation must be reduced as well. Bearing in mind that the major component of core inflation is labor costs, and that these, in turn, are determined by the interaction of compensation and productivity trends, it would appear that policies that would enhance capital formation and capital investment thus boosting productivity and lowering the cost of capital would go a long way toward reducing core, or underlying inflation.

In this regard, the Reagan Administration has made a good start, with its emphasis on the supply side. Unfortunately, the program as actually enacted went further than enhancing capital formation and providing incentives for business to invest. Although the personal tax cut was indeed structured so as to provide an increase in savings, the pool of savings does not seem to be expanding enough to make up for the loss in revenues that the Administration, itself, believes will occur because of the tax cut and the huge increases projected for defense spending. When combined with the high rates of interest generated by financial markets' fears regarding future trends in the overall demand for funds compared with their supply, this program has forced business to trim its investment plans thus frustrating its supply side aspects.

At this point, it would appear that a midcourse correction is in order. For the first time since our protracted bout with inflation began, we have an opportunity to unwind the ever rising price spiral. It depends — not just on the availability of food and fuels, and not on the willingness of business and labor to price products and services realistically. Rather, it depends on a few politicians in Washington and their willingness to make the hard choices necessary to keep inflation down for the count. H